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In the Supreme Court of the United States

OCTOBER TERM, 1935

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

JOHN J. WATTS

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

HUGH C. SICARD

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

PARKER SLOANE

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the

United States Circuit Court of Appeals for the Second Circuit entered in the above causes on March 11, 1935, reversing decisions of the Board of Tax Appeals.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 58) is reported in 28 B. T. A. 1056. The opinion of the Circuit Court of Appeals is reported in 75 F. (2d) 981.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on March 11, 1935. A petition for rehearing was denied on March 27, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

Pursuant to an agreement executed in 1924 with Vanadium Corporation, the three taxpayers, owning all the stock of Alloys Corporation, exchanged their stock for Vanadium stock and short-term bonds to be secured by the assets of Alloys, and to be guaranteed by Vanadium as to principal and interest, with the privilege of paying the principal on 90 days' notice. The Vanadium stock which the taxpayers received in exchange for their Alloys stock was to be held in escrow during the year 1925, and the exact amount to be delivered to the taxpayers would depend on the earning power of

Alloys demonstrated during 1925. Alloys was dissolved in 1928. The questions presented are:

1. Whether the taxpayers are relieved from taxation on the gain realized from the transaction by the exceptions to Section 203 (a) of the Revenue Act of 1924. This depends upon whether the definition of the term "reorganization" contained in Section 203 (h) (1) (A) of the Revenue Act of 1924 should be limited to transactions which partake of the nature of mergers or consolidations.

2. Assuming that the transaction was a reorganization within the meaning of Section 203 (h) (1) (A) of the Revenue Act of 1924, whether the gain realized from the transaction by the taxpayers should be recognized to the extent of the principal amount of the Alloys bonds, namely, $1,161,184.50, under Section 203 (d) (1) of the Revenue Act of 1924. This depends upon whether the bonds are "securities" within the meaning of Section 203 (d) (1) of the Revenue Act of 1924.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 12–16.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 59–68) may be summarized as follows:

The three taxpayers owned all of the stock of United States Ferro Alloys Corporation, hereafter called Alloys, consisting of 30,000 shares with a par

value of $100 each. On or about December 6, 1924, one of the taxpayers, acting in behalf of the others, as well as himself, entered into a written agreement, with the Vanadium Corporation of America, hereafter referred to as Vanadium. (R. 59–60.)

According to the agreement, the taxpayers agreed to exchange all of their Alloys stock for 66,666⅔ shares of Vanadium, together with bonds aggregating $1,161,184.50 secured by a trust mortgage on the Alloys plant at Niagara Falls and guaranteed as to payment of principal and interest by Vanadium. The mortgage agreement was to provide that Vanadium should always have on hand for the use of the Niagara Falls Plant at least sixty days' supply of such materials and products as might be necessary to employ the power then under contract, and there was to be a clause providing for the privilege of payment of the principal at any time on 90 days' notice. (R. 62–64.) The agreement also provided that upon receipt of the Alloys stock, Vanadium would immediately pay $338,-815.50 to certain creditors of Alloys (R. 64–65).

It was agreed that the contract should be carried out on December 19, 1924, at which time all of the stock of Alloys duly endorsed, together with resignations of the officers and directors of Alloys, should be delivered to Vanadium, and that Vanadium should thereupon place 66,666⅔ shares of its stock in escrow with a trust company, and should deliver to Alloys the bonds described above and immediately pay the amounts it had assumed to

pay under the contract (R. 65–66). The agreement also provided for a complete audit of the business, properties, and profits of Alloys, and the parties agreed that the escrow deposit of Vanadium stock should be dissolved on January 1, 1926, and that the exact number of shares of Vanadium to be then delivered to the taxpayers should be determined on the basis of the earning power of Alloys demonstrated during 1925 (R. 66).

By a supplemental agreement dated December 18, 1924, the amount of stock which Vanadium was to exchange with the taxpayers was reduced to 33,333⅓ shares. The stock of Vanadium was of no par value, and for the purposes of the agreement its value was fixed at $30 per share. The contract was duly executed in accordance with its terms, but as a result of the demonstrated earning power of Alloys during the year 1925 only 32,103 shares of Vanadium were delivered to the taxpayers. Concurrently with the closing of the transaction, Vanadium paid to the creditors of Alloys the sum of $338,815.50. (R. 66.) In July 1928 a certificate of the dissolution of Alloys was filed in the office of the Secretary of the State of New York (R. 67).

In the respective deficiency letters to the three taxpayers, the Commissioner held in substance that the transaction involved was a sale of the 30,000 shares of Alloys for the sum of $2,500,000, and determined that each of the taxpayers derived a capital net gain of $507,534.65 (R. 67–68). The

taxpayers appealed to the Board of Tax Appeals on the ground that the transaction was a tax-free reorganization under Section 203 of the Revenue Act of 1924, and that no gains should be recognized. The Board of Tax Appeals decided, with five members dissenting, in favor of the Commissioner and determined a deficiency of more than $63,000 in the case of each taxpayer for the year 1924.

The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals and held that the transaction was a reorganization under the statute and the applicable Treasury regulations. The Commissioner of Internal Revenue filed a petition for rehearing on the ground that the decision of the court in the instant case, in failing to hold that the taxpayers had realized a gain at least to the extent of the value of the bonds received by them in the transaction, was inconsistent with a decision of the same court in *Worcester Salt Co.* v. *Commissioner*, 75 F. (2d) 251, in which it was held that bonds are merely an evidence of indebtedness and are not "securities" within the meaning of the reorganization provision of the Revenue Act. The Circuit Court of Appeals denied the petition for rehearing on March 27, 1935.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In failing to hold that the definition of the term "reorganization" contained in Section 203 (h) (1) (A) of the Revenue Act of 1924 should be

limited to transactions which partake of the nature of mergers or consolidations.

2. In giving effect to an administrative construction which is inconsistent with the statute.

3. In denying the petition for rehearing and failing to give effect to its own decision in another case that bonds are not "securities" within the meaning of Section 203 (d) (1) of the Revenue Act of 1924.

4. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The construction placed by the court below upon the reorganization provisions of the Revenue Act of 1924 is inconsistent with the construction placed by this Court upon similar provisions of the Revenue Act of 1926 in *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462. Section 203 (h) (1) (A) of the Revenue Acts of 1924 and 1926 defines reorganization as meaning "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation)." In the *Pinellas Ice Co.* case, although one corporation acquired substantially all the properties of another corporation, this Court held that the transaction was not a reorganization within the meaning of the statute because it had

"no real semblance to a merger or consolidation." This Court indicated that while the words within the parentheses in clause A of Section 203 (h) (1) may not be disregarded, they modify the words "merger or consolidation" and may not be considered as sufficient in themselves. In the instant case, the lower court held that the mere acquisition of a majority of the stock of another corporation was sufficient to constitute a reorganization within the meaning of the statute without considering whether the transaction bore a real semblance to a merger or consolidation.

2. For the reasons given above, the decision of the court below is also in conflict with a decision of the Circuit Court of Appeals for the Tenth Circuit in *Prairie Oil & Gas Co.* v. *Motter,* 66 F. (2d) 309; with a decision of the Circuit Court of Appeals for the Eighth Circuit in *Von Weise* v. *Commissioner,* 69 F. (2d) 439, certiorari denied, 292 U. S. 655; with a decision of the Circuit Court of Appeals for the Seventh Circuit in *John A. Nelson Co.* v. *Commissioner,* 75 F. (2d) 696, in which a petition for certiorari has been filed, No. 64, October Term, 1935; and with a decision of the Circuit Court of Appeals for the Fourth Circuit in *G & K Mfg. Co.* v. *Commissioner,* 76 F. (2d) 454. All of these authorities clearly show that the words "merger or consolidation" in clause A may not be disregarded, and that while the parenthetical clause expands the meaning of those words, it is essential that the

transaction partake of the nature of a merger or consolidation.

3. The decision below is believed to be erroneous. The decision of the court below rests upon a Treasury regulation, which cites as an example of a reorganization a case where one corporation acquires a majority of the voting stock and a majority of the total number of shares of all other classes of stock of another. This is merely a repetition of the words in the parentheses of clause A of Section 203 (h) (1). This Court held in the *Pinellas Ice Co.* case, *supra,* that the words in the parentheses expand the meaning of "merger" or "consolidation", but indicated that the transaction must first bear a real semblance to a merger or consolidation. Since that is the proper construction to be placed upon the words of the statute, *a fortiori* a similar construction must be placed upon the corresponding provision of the Treasury regulation. The court below should have inquired whether the transaction bore a real semblance to a merger or cosolidation. The evidence shows that the parties to the transaction intended that Alloys should continue in existence as a separate and independent entity and it was not until four years later that Alloys was dissolved.

The court below also relies upon the principle of legislative sanction of the Treasury regulation, because the Congress reenacted the statutory provision to which the regulation refers. But that

rule of construction has never been applied in a case where the regulation conflicts with the terms of the statute, or with the construction placed upon the statute by this Court.

4. The decision of the court below insofar as it failed to hold that the taxpayers had realized a gain at least to the extent of the value of the bonds received by them in the transaction, is inconsistent with another decision of the same court. A short time prior to the rendering of the decision in the instant case, the court below decided *Worcester Salt Co.* v. *Commissioner,* 75 F. (2d) 251, in which it was held in effect that bonds are not *"securities"* within the meaning of the reorganization provisions of the Revenue Act. This was the first suggestion that a gain upon a reorganization should be recognized when represented by bonds, and the Commissioner of Internal Revenue promptly filed a petition for rehearing in which he contended that he should have the benefit of the *Worcester Salt Co.* decision and that the gain upon the transaction in question should be recognized to the extent of $1,161,184.50, representing the principal amount of Alloys bonds which the taxpayers received in addition to Vanadium stock. In *John A. Nelson Co. v. Commissioner, supra,* it was held that preferred stock does not represent the quality of interest requisite for a reorganization. The Government does not oppose the petition in the *John A. Nelson Co.* case, and if this Court is to pass upon the question whether preferred stock satisfies the

statute, we urge that the similar question concerning bonds should be considered in this case.

5. The question presented is of considerable general importance. The Treasury Department advises that there are a number of cases pending in which the same principles of law are involved.

Wherefore, it is respectfully submitted that this petition for writs of certiorari to review the judgments of the Circuit Court of Appeals for the Second Circuit should be granted.

STANLEY REED,
Solicitor General.

JUNE 1935.

APPENDIX

Revenue Act of 1924, c. 234, 43 Stat. 258:

SEC. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

* * * * *

(b) (2) No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(d) (1) If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * *

(h) As used in this section and sections 201 and 204—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at

least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(i) As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

(U. S. C., Title 26, Sec. 934.)

Treasury Regulations 65, relating to the Revenue Act of 1924:

ART. 1574. *Exchanges in connection with corporate reorganizations.*—Since corporate reorganizations which result only in a change in form and which do not substantially affect the property interests either of the shareholders or of the corporations may be required or may be made desirable by business conditions, State laws, or other causes, the statute provides that no gain or loss shall be recognized to the shareholders from the exchange of stock made in connec-

tion with the reorganization nor to the corporations from the exchange of property made in connection with the reorganization. If two or more corporations reorganize, for example, by either (1) the dissolution of corporation B and the sale of its assets to corporation A, or (2) the sale of its property by B to A, or (3) the sale of the stock of B to A, or (4) the merger of B into A, or (5) the consolidation of A and B, or (6) the acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, or (7) the transfer by A of all or a part of its assets to B where immediately after the transfer A or its shareholders are in control of B, then no taxable income is received from the transaction by corporation A or B if the sole consideration for the transfer of the assets is stock or securities of corporation A or B; and no taxable income is received from the transaction by the shareholders of either corporation A or corporation B if the sole consideration received by the shareholders is stock or securities of corporation A or B. Furthermore, if the reorganization is accomplished by the transfer by corporation A of a portion of its assets to corporation B in exchange for the stock of corporation B and corporation A distributes as a dividend to its shareholders the stock of corporation B, no taxable income is realized by the shareholders from the receipt of such dividends. (See art. 1576.)

In conformity with the principle of ignoring for tax purposes those reorganizations which result merely in a change in form, the statute provides further that the

stock received by the shareholders in connection with the reorganization shall have the same basis for the purpose of determining gain or loss from its subsequent sale as the stock surrendered by them and that the assets acquired by a corporation a party to the reorganization shall have the same basis for the purposes of depreciation, depletion, and the determination of gain or loss from subsequent sale as they had in the hands of the corporation from which they were acquired. (See arts. 1596–1598.) The exchanges made by both the shareholders and the corporations in connection with a reorganization are ingnored and both are treated thereafter as if the reorganization had not occurred.

Adequate provision is made in the statute for cases in which income is actually realized by the shareholders in connection with the reorganization through the receipt of cash or property other than the stock of a corporation a party to the reorganization. (See art. 1575.) In such cases the gain to the shareholder is recognized and taxed, but in an amount not exceeding the amount of the money or the other property received in connection with the reorganization. If the money so distributed in connection with the reorganization has the effect of the distribution of a taxable dividend, such gain is taxed not as a capital gain but as an ordinary dividend subject to the surtax rates. While placing no obstacle in the way of genuine reorganizations, the statute does not allow the use of reorganizations to avoid the tax.

Records in substantial form, showing the basis of the stock or property exchanged,

and the amount of property or money received in exchange, must be kept to enable the determination of gain or loss from a subsequent disposition of the stock or property received or exchanged.

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